Switzer Super Report

Thursday 15 October 2015

A change of plan

After the big rise of last week, we've seen a lot of range trading this week, and as Charlie Aitken says today, this volatility will probably continue for the remainder of 2015. In these kinds of times, a good response is to concentrate portfolios in high quality and certainty.

Charlie has always been a big advocate of the better opportunities offshore, but you don't always have to buy international stocks to find them. One company he likes because of its global diversification, and which may be on its way to $100, is Macquarie.

Also in the *Switzer Super Report* today, Tony Featherstone explains why you can often find better value in IPOs after the fact, and lists three that are doing well.

Sincerely,

Peter

Peter Switzer

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Macquarie Group - the pathway towards $100

by Charlie Aitken

No doubt this is a volatile period in global and domestic equity markets. I expect that to continue for the remainder of 2015, which means the right response is to concentrate portfolios in high quality and certainty.

Unfortunately, the presence of extreme volatility almost ensures there isn't much certainty. That is clearly true at the macroeconomic level, but at the company specific level you can still find some certainty.

Quality not quantity

To my way of thinking, this is the time to reduce the number of stocks in portfolios. It's a time to let your winners run, or even buy a little more of them. On the other hand, the recent bounce driven by short-covering in low quality, uncertain, cyclical companies is most likely giving you a chance to get out. The key to successful investing remains to let your winners run and be a ruthless cutter of losers. That is particularly so in the current environment. Today I am going to write about a large cap Australian winner that I forecast to continue to be a winner: Macquarie Group (MQG).

I believe Macquarie is a structural growth at a reasonable price stock (SGARP). Structural growth is never outright cheap, but relatively cheap vs. the growthless peers of the S&P/ASX200. In fact, Macquarie is one way of Australian investors actually buying some global growth exposure on the ASX. That alone attracts me to Macquarie: its uniqueness as an offshore earning growth stock with nothing to do with China.

Macquarie is not the freewheeling investment bank of the pre-GFC era. It is now one of the world's biggest asset managers and its earnings and dividends are far more forecastable. The reduction in earnings volatility has led to Macquarie being more rated like a fund manager than an investment bank. However, the P/E re-rating to global and domestic asset management peers has further to run in the years ahead.

Macquarie is in a consistent earnings upgrade cycle: this is what I describe as structural growth, Macquarie's FY16 consensus EPS forecast has risen from $4.50 to $5.87 since the beginning of 2015. That's a +30% upgrade to consensus FY16 EPS growth forecasts in nine months and I think those numbers have further positive revision to come.

More than that

But Macquarie is not just an EPS growth stock, it's also a rising return on equity (ROE) story. These are most often the most powerful investment stories: not only are earnings growing but ROE is also growing.

Last week, Macquarie embarked on another large scale earnings and ROE enhancing transaction. My fund supported the $400 million institutional capital raising to fund the acquisition, feeling through time this deal will lead to further earnings and ROE enhancement. There is also a share purchase plan (SPP) for eligible shareholders.

The transaction was purchasing the $8.2b Esanda dealer finance portfolio from ANZ. The Esanda portfolio comprises retail and wholesale dealer finance on motor vehicles across Australia and had a book value of $7.8 billion. That $7.8 billion book value is broken into $6.2 billion in retail loans and $1.6 billion in wholesale loans. The transaction lifts Macquarie total leasing book portfolio to $17 billion. Most analysts forecast the deal to add 10cps to EPS in the first year.

However, the post deal EPS upgrade wasn't the only positive adjustment to consensus Macquarie EPS forecasts. Macquarie also lifted earnings guidance for the 1HFY16 to be 55% higher than the previous corresponding period. Macquarie also guided the 1HFY16 dividend to $1.60 per share (40% franked, 50% payout ratio) and reaffirmed its sustainable dividend payout target range of 60% to 80%. Below are our forecasts and prospective multiples for the years ahead, based off a share price of $80.00.

	FY16	FY17	FY18
NPAT	$1.95B	$2.2B	$2.4B
EPS	600c	660c	700c
EPS Growth	19.50%	10%	6%
P/E	13.3x	12.1x	11.4x
PEG Ratio	.68x	1.21x	1.9x
P/book	1.6x	1.5x	1.5x
Dividend	375c	415c	460c
Dividend growth	13.6%	10.6%	10.8%
Dividend yield	4.7%	5.1%	5.8%
ROE	14.3%	14.6%	15%

Macquarie offers earnings growth, dividend growth and ROE growth. It also now sources more than half its earnings from offshore, with an overweight to the US dollar. If I am proven right about my long-term A$/US$ target of 65 US cents, then Macquarie will be a major beneficiary on earnings translation and therefore further earnings and dividend growth.

The transformation

This doesn't happen, of course, without a strong management team and board. I think there should be no doubt that CEO Nick Moore has transformed Macquarie for the better. There is no better example of this than Macquarie's ability to raise fresh equity capital ABOVE the prevailing share price because investors, including my fund, believed the deal they were doing was sensible, well priced, and increasing the future growth profile. It was also a smaller equity raising than expected.

To put this in context, other Australian "banks" have been raising fresh equity capital AFTER their share prices have fallen 20% and at deep DISCOUNTS to prevailing share prices. Don't even start me on the Origin Energy (ORG) debacle or BHP Billiton considering a "hybrid issue" to fund a dividend gap. Pound for pound I think Macquarie has the best medium-term outlook on ANY Australian top 20 stock. It is seeing earnings upgrades in a sea of downgrades. This is a great Australian based global growth exposure. In effect, Macquarie is *"exporting Australian superannuation"* and generating increase returns on that "exporting.

Over the last few years, I have consistently encouraged you to *"lose the home bias"* in asset allocation. Whether that was via buying ASX listed US dollar earners, allocating money to a global fund manager, or physically shorting the Australian dollar, it has been my most consistent and correct strategy theme. I've even now set up a global fund – that's how much I believe in the opportunities offshore being greater than domestically for the foreseeable future.

Buying Macquarie shares is one clear way of "losing the home bias". I believe buying and holding Macquarie shares will continue to be rewarding over the years ahead. It is quite feasible to forecast Macquarie earning EPS of 700c in FY17 and the market paying 14.3x for that EPS stream. That would equate to a $100.00 Macquarie share price in two years' time.

Let's see what comes but I for one am backing Macquarie to continue to deliver over the years ahead. Growth and certainty are harder to find by the day: Macquarie offers both.

Disclaimer: The AIM Global High Conviction Fund owns Macquarie shares. The AIM Global High Conviction Fund does business with Macquarie Equities.

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3 floats worth keeping an eye on

by Tony Featherstone

This year's Initial Public Offering (IPO) market has been solid rather than spectacular. Fifty-five companies collectively raised $4.4 billion through IPOs and listed on ASX in the calendar year to August 31, *Switzer Super Report* analysis shows.

At this rate, the 2015 IPO market will be well down on last year, and thankfully so. Last year's IPO market broke records as $18.6 billion was raised through 81 listings. A rising share market, the blockbuster Medibank Private offer, and strong IPO sentiment drove capital raisings.

This year's IPO market was expected to slow. No multi-billion-dollar household-name IPOs were slated, float fatigue started to creep in, and the share market correction in August and September made vendors nervous about rushing to market.

The Link Administration Holdings IPO, covered by Paul Rickard on Monday, will test investor appetite for floats. Seeking $946.5 million, the float has been mooted for several years. It will be this year's largest IPO, eclipsing MYOB's $739 million raising.

A successful listing could spark an end-of-year float rush. The fourth quarter is typically strongest for IPO volumes as vendors race to close their offers before Christmas. Better share market conditions in October and November would buoy vendors. Baby Bunting Group's listing this week, up 31% on debut, will also boost confidence.

As to share-price gains, the 2015 IPO crop (to August 31) has had a median gain of 2% over the issue price, our analysis shows. In relative terms, that's an okay result given share market falls this year, and within that there have been several strong performances from tech floats.

Future Fibre Technologies, Superloop, Appen and Reffined headline the list of IPO performers so far this year. They reinforce investor interest in emerging information technology and telecommunication companies, but come with higher risk.

Look for the laggards

Like a house on auction, IPOs are often overhyped and dressed up to get the best price. Investors scramble for stock in the float, miss out on all or some of their allocation, and give up on it in the aftermarket if the share price disappoints. They judge the company's quality by its share-price performance against the issue price – a sure-fire way to lose money.

The best value often emerges in the aftermarket when an IPO falls for no good reason, its stock is readily available, and there is more history as a listed entity. Having analysed hundreds of IPOs in the past decade, I'm cynical about what is often reported in prospectuses.

Other factors are complicating IPOs. Escrow anniversary dates can lead to stock being dumped by early investors when their restricted securities are allowed to be sold. Keep a close eye on floats during one- or two-year escrow dates if they have a high proportion of restricted stock. Excessive selling can create opportunity.

Hedge funds are also changing the IPO aftermarket. Algorithmic trading programs are selling stock that drops below the issue price on its debut trading day. A leading small-cap fund manager I know sells any float that dips below the issue price within days of listing.

These dynamics create opportunities for long-term value investors, who can watch and wait for better value in IPOs, instead of chasing them in the offer

period or in the early aftermarket. Some floats, of course, warrant early buying. But the days of an easy 5-10% “stag gain” on the first day of trading for floats, collectively, are long gone.
These three recently listed companies trade below their issue price and are worth watching.

1. Costa Group Holdings (CGC)

Yes, it is harsh to call Costa a laggard when it is trading just below its $2.25 issue price at $2.21. Australia’s largest grower and marketer of fruit and vegetables raised $551 million through an IPO and listed on ASX in July – just before the share market correction quickened.

Costa was $1.77 in early September and has steadily tracked back to its issue price. It’s another example of why it pays to watch floats in the aftermarket and buy them when they are cheaper. It is a quality company in a sector with excellent long-term prospects.

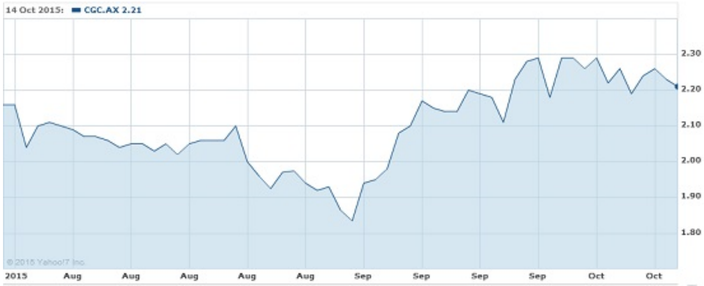
Agribusiness stocks have stood out this year. Organic food provider Bellamy’s Australia, almond producer Select Harvest, feed supplier Ridley Corp, Elders and Farm Pride Foods have rallied. Chemical supplier Nufarm and Incitec Pivot are improving.

The lower Australian dollar is helping export sales, amid rising demand from Asia for Australian food. Free-trade agreements, while usually taking years to affect corporate earnings, have boosted sentiment towards agribusiness, and operational restructures across the sector in the past few years are paying off.

Costa is superbly positioned to capitalise on the “dining boom” as middle-class consumption in Asia takes off in the next 15 years and diets include more protein. The company is not well covered by analysts, but those who follow it have buy recommendations and a median price target of $2.79, suggesting reasonable upside from the current price.

Costa’s first reported full-year revenue and underlying earnings slightly exceeded prospectus forecasts. The return of El Nino conditions and less rainfall in Eastern Australia this summer is a concern, but it looks like one of the higher-quality agribusiness companies on ASX.

Costa Group Holdings



***Source**: Yahoo!7 Finance, 15 October 2015*

2. Argo Global Listed Infrastructure (ALI)

The Argo infrastructure fund listed on ASX in July after raising $286 million at $2 a share. Apart from brief gains in September, the listed investment company has mostly traded below the issue price and was $1.95 this week.

The fund provides exposure to a portfolio of global infrastructure stocks and is yet another LIC IPO that has come to market in the past two years.

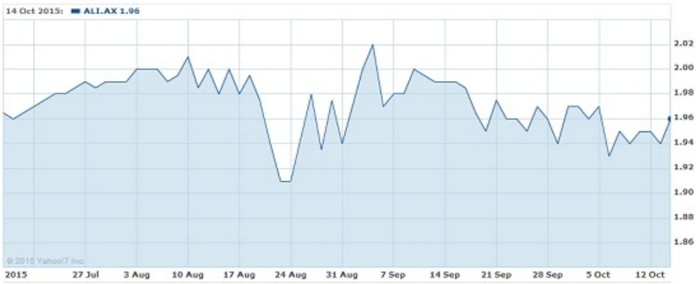
It is trading just below its latest stated net tangible asset (NTA) value of $1.96, although the issue of options at $2, assuming they are exercised in due course, could dilute the NTA, meaning Argo could trade at a premium to its asset backing.

I like the look of this fund. Argo is one of the market’s best-regarded investment managers and its flagship LIC, Argo Investments, typically trades at a premium to NTA.

Global infrastructure is an interesting asset class given many emerging and developing countries badly need to upgrade roads, rail, ports, and electricity assets as the population grows. Historical underinvestment in infrastructure and continued privatisation of government-owned assets overseas are other sector tailwinds. As is a lower Australian dollar in the next 12 months, given the Argo fund is expected to be mostly unhedged.

Global infrastructure suits SMSFs that want exposure to this more defensive asset class. With many Australian LICs trading at significant premiums to NTA – and best avoided at current prices – the Argo infrastructure fund has appeal.

Argo Global Infrastructure Fund



***Source**: Yahoo!7 Finance, 15 October 2015*

3. MYOB Group (MYO)

The market's largest IPO so far, MYOB Group, has been an early disappointment. The accounting software provider raised $739 million at $3.65 a share and listed in May. It has mostly traded below the issue price and was $3.30 this week.

MYOB is approaching value territory. Its first-half result was slightly ahead of prospectus forecasts and management reiterated full-year guidance. It rallied on the news, but remains well down on the 52-week high of $3.92.

MYOB has a strong position in lucrative accounting software markets in Australia and New Zealand. Recurring revenue makes up most of its sales. Accounting software is a lucrative business and has a beautiful business model when it works.

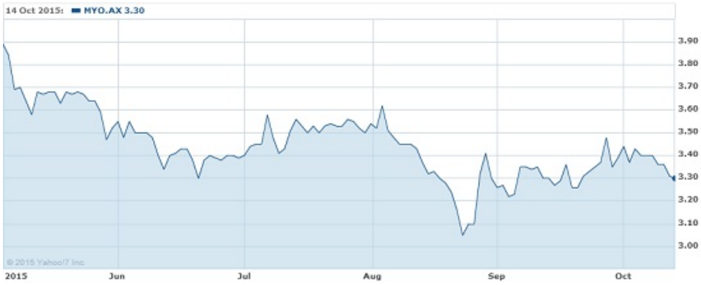
Of five broking firms that cover MYOB, two have a buy recommendation and three have a hold. Analysts are starting to upgrade recommendations and a median price target of $3.68 suggests MYOB is a touch undervalued and offers a reasonable margin of safety at the current price.

MYOB looks well positioned as more small and medium-size enterprises migrate to the cloud and use its software. Its rival, Xero, is making inroads but accounting software is highly "sticky" once companies get used to using it. It is hard to swap providers.

MYOB trades on a PE of about 20 times 2015-16 forecast earnings. That does not seem excessive for a well-run company that deserves a valuation premium given its industry position.

My sense is MYOB came to market a touch too expensive and has suffered from general market volatility. It would look more interesting closer to $3, but appeals at current prices.

MYOB Group



***Source**: Yahoo!7 Finance, 15 October 2015*

Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at October 14, 2014.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Macquarie upgraded Premier Investments (PMV) to Outperform from Neutral. Buy/Hold/Sell 2/4/0. Macquarie has re-reviewed the outlook for the company's overseas expansion, while transferring coverage to a new analyst and upgrading the recommendation. Macquarie is now forecasting 3-year EPS compound annual growth rate of 12%, on conservative estimates primarily driven by overseas expansion. Smiggle is the star performer in the group, key risks are with the older, established brands.

UBS has upgraded OceanaGold (OGC) to Neutral from Sell. Buy/Hold/Sell 3/2/0. UBS maintains its 2016 and 2017 gold price forecast at US$1,250/oz. Any downside from here is expected to be ultimately contained. A lower assumption for the Australian dollar helps lift valuation, but 2015 earnings have been reduced by 11%, and 2016 by 9.0%, following a cut to copper price forecasts.

Macquarie has upgraded Suncorp (SUN) to Outperform from Neutral. Buy/Hold/Sell 1/6/1. Macquarie has undertaken detailed reserving analysis for Suncorp and introduced a comparative absolute valuation for the stock as the broker does for QBE Insurance. An upgrade to FY16 forecast reserve releases leads to an upgrade in earnings forecasts.

In the not-so-good books

Macquarie has downgraded CSR to Underperform from Outperform. Buy/Hold/Sell 4/2/1. Macquarie is forecasting a big drop in housing commencements in 2016 as the pace of population growth slows, while housing supply continues to grow well above trend. While Australian listed building stocks are in more robust shape now following restructures, and balance sheets are in good shape, the broker has nevertheless downgraded expectations. While CSR has been sold off to historically low valuation, a housing rollover and weak aluminium prices will dampen any rebound possibility.

The above was compiled from reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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Short n' Sweet - key person risk

by Penny Pryor

A company's fortunes should never depend solely on who is at the top, however the quality of leadership is a key determinant in how a company performs, both on its balance sheet and on the stock market.

Mike Smith may have been heralded as a visionary leader of ANZ, but when it was announced Shayne Elliot would be taking over the reins, ANZ's share price rose. ANZ is still the poorer cousin of the big four and Paul Rickard rates the banks like this:

1. NAB
2. CBA
3. Westpac and
4. ANZ

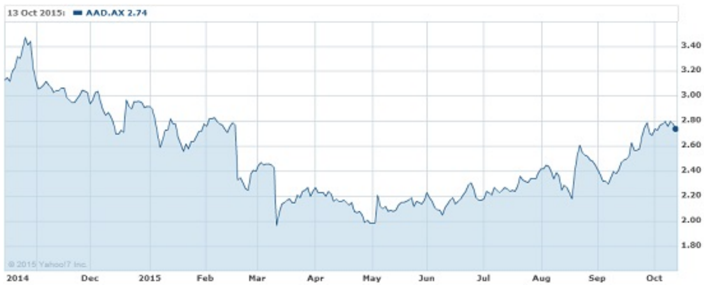
Already, Shayne Elliot has said he wants the bank to reduce its focus on Asia and concentrate more on the domestic mortgage market in order to move up the Big Four rankings. If he can do that, he will definitely become a CEO to be reckoned with.

Don Meij of Dominos Pizza is another 'hero' CEO who is often talked about. Don started as a pizza delivery guy and gradually moved up the ladder. He is very obviously passionate about pizza and his brand, and is devoted to the company and what it can deliver. Although expensive at a FY16 forecast PE of 47, everyone still loves the Meij story and the share price is rising.

Christine Holgate, CEO of Blackmores, understood the benefits of selling to China early on, and Blackmores share price has risen pretty much consistently since it hit $100 way back in August after a record annual profit. Holgate is a regular on Peter's show on Sky News Business channel and her style of leadership is evident in her treatment of employees. In August she gave most of her 900 staff an extra six weeks' pay on the back of the company's record annual profit announcement. The company also has a profit share scheme, which gives 10% of profits back to its staff. Of course, it can work the other way too. The departure of Woolworths CEO Grant O'Brien in June was seen as the first step in a long restructuring process for the supermarket giant if it wants to catch up with Coles (Wesfarmers).

And then there are the inexplicable CEO movements. When it was announced in April that Ardent Leisure had appointed former magazine editor Deborah Thomas, its shares plummeted more than 19% in one day. Thomas replaced Greg Shaw, who served close to 13 years in the role. But while the market and some professional investors focussed on her magazine experience, and therefore her perceived lack of managerial experience, they neglected to take into account that Thomas had been with the company as a non-executive director since December 2013.

Thomas granted some interviews immediately after the announcement, but has since gone to ground – probably to concentrate on running a large listed company. And as the share price chart below shows, she hasn't done too badly.



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What’s in your SMSF is not yours to play with

by Tony Negline

My Mum has often said “desperate times call for desperate measures”.

This came to mind when reviewing two recent Federal Court cases, which involve accessing money in an SMSF for business and personal purposes. In both cases, the trustees were fined.

Overall, the temptation not to raid the SMSF’s bank account proved too great.

This is a major risk for all SMSFs, especially those who run businesses.

People dip into their SMSF capital to prop-up a business that will probably fail anyway. They prolong the inevitable death of the business and end up losing it, and sometimes a big portion of the super fund’s assets via fines and penalties.

Early Sunshine

Early Sunshine Pty Ltd was the trustee of an SMSF. The members of the fund ran a NSW-based freight trucking business, which had suffered from poor trading since 2001 after it lost a major client. From 2007, the survival of the business was put under further strain by the GFC and slow payment of invoices by clients.

Between June 2007 and June 2011, just over $550,000 of SMSF money was loaned to the business. No loan was more than $20,000 and the average loan was about $7,800. Each loan was short-term, typically about three weeks, but no interest was paid on these loans and no security was sought for these loans.

One small loan was made to another related party. This loan was made without security but interest was payable.

The business’ difficult trading conditions created obvious cash flow problems. It regularly had insufficient funds to pay staff salaries and wages. The proprietors could either keep the business running or close it down. They elected to temporarily use the SMSF’s money to prop up the business.

All loans from the SMSF were repaid in full.

The ATO was alerted to the super law breaches by the fund’s external auditor.

In August 2011, the members of the fund moved their investments to TWU Super (an industry fund related to the transport industries) and since that time the fund has been dormant.

When push came to shove, the trustees made full admissions to the ATO of their wrongdoing and said they were sorry for their actions.

Given their contrite demeanour, the super fund doesn’t appear to have been made non-complying, which would have seen the fund’s tax rate increase to 47%. In the first year this penalty is imposed, it applies to the assets of the super fund and by the time the ATO might have imposed this very little remained in the fund.

The breaches committed by Early Sunshine were:

- Sole purpose test – the fund wasn’t run solely for the purposes allowed in the super legislation because its assets were loaned to a related party, which means the fund members were receiving a benefit from the fund before they were entitled.
- In-house assets test – this test restricts the amount of money a super fund can loan to parties related to the fund including related businesses; this test also restricts loans and

leases to related parties

- Arm's length dealing – this rule requires super funds to only conduct transactions in such a way that the super fund at least receives commercial terms or better

Fines

The Federal Court imposed fines of $13,000 on each of the individuals involved in the super law breaches and each had to pay $5,000 to the ATO towards its costs of prosecuting this case.

However, the fines could have been $220,000 plus a substantial amount more for the ATO's costs.

Ryan

In 2007, Mr and Mrs Ryan sold an unsuccessful dry cleaning business.

The sale proceeds didn't cover the line of credit they had taken on their home loan to support the business. By June 2009, they were struggling to meet their personal expenses and the interest on the line of credit.

They solved this cash flow shortfall by borrowing a total of $210,000 from their SMSF between June 2009 and June 2012.

Again, the loans were unsecured, had no interest payable and no repayment term. At the time of the Court hearing, less than $30,000 of the loans had been repaid.

As with the Early Sunshine case, the Tax Office was alerted to the breaches by the fund's external auditor and decided to take action because this was the second time the Ryans had used their super fund money for personal or business purposes.

The Ryans had breached the super laws between 2001 and 2004 when they "borrowed" money from their fund but the Ryan's and the ATO formally agreed that no action would be taken if these loans were repaid. This money was repaid so the Tax Office let this matter rest.

This time, the breaches committed by the Ryans were the same as the Early Sunshine fund plus they also provided financial assistance to a fund's members or their relatives via direct loans.

Fines

As with the Early Sunshine case, the Ryan's could have been fined $220,000 plus costs.

In the end, the AAT imposed a fine of $20,000 on Mr & Mrs Ryan. The AAT had agreed that the Ryans should also pay the ATO's costs but, at the time of writing, no decision had been published about this.

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Santos versus Woodside

by Questions of the Week

Question: I would appreciate your thoughts on Santos, Origin Woodside and the LPG sector generally as at the moment my losses on these shares are quite high.

Answer (By Paul Rickard): I don't really like the sector and can't yet see any reason to go long oil/lng stocks. If I had to choose, I prefer Woodside in the short term (less risk), and for the long term, probably Santos. In regard to the latter, I am wary that the market might yet force Santos into a capital raise.

For a collected opinion, here is what the brokers say. According to FN Arena, on a sentiment/discount scale, Santos is most preferred, and Woodside the least. Here is how the stocks stack up:

- Origin (ORG) – sentiment +0.3, target price $6.69
- Santos (STO)– sentiment +0.9, target price $8.03
- Woodside (WPL) – sentiment -0.1, target price of $32.14

(Sentiment – scale -1.0 is most negative, +1.0 is most positive)

Question: I have been most interested in Capitol Health (CAJ) and have bought at several levels. They are in a reasonable sector and management appears OK. They are expanding well and have good balance sheets. Debt also seems manageable. Why would then their price drop from 1.08 to 60c?

Answer (By Paul Rickard): Not sure whether I can really explain the price fall in Capitol Health (CAJ), apart to note the exit of a couple of substantial shareholders (MLC etc).

Also, the stock was trading at pretty racy multiples – 2015 EPS of 2.49c per share, which at a price of $1.00, put the stock on a historical multiple of 40.2 times – back at $0.60, a multiple of only 24.1 times.

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